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ICPS newsletter

Economic Decline to Continue in 1999-2000

New issue of "Quarterly Predictions" was published last week. In this issue the International Centre for Policy Studies presents renewed scenario of economic development in Ukraine for 1999 and first forecast for 2000.

ICPS economists expect Ukraine's GDP to decline by 4% in 1999. This will mainly come from the burdensome fiscal pressure on buoyant industries, decline in investment before the presidential elections, and the permanent risk of financial destabilization. The new president (elections will be held at the end of 1999) needs to enact vigorous reforms to deal with chronic problems. The decline will slow down to 1% in 2000.

In the first quarter of 1999 Ukraine's real GDP declined by 4.8% compared to the first quarter of 1998. This indicates that the situation has worsened compared to 1998, when GDP decreased by 1.7% in the same quarter.

The factors that contributed to the decline were:

- A 36% fall in exports to Russia and other CIS countries compared to the first quarter of 1998.

Anti-market policy in Ukraine will lead to social unrest or loss of sovereignty

Centre's forecast for economic trends in 2000 will fail, if a candidate who advocates the following policy is elected:-

- Restrict market mechanisms.
- Provide state subsidies to ineffective enterprises.
- Suppress farmers' rights to land ownership.
- Increase budget expenditures and tighten monetary policy.
- Breach collaboration with international financial organizations.

Implementation of these types of economic programs would rapidly unbalance the budget, due to the widening social programs and an increase in subsidies to loss-making enterprises. The hryvnia will sharply devalue and prices will rapidly grow. If the government tries to deal with this problem by imposing administrative restrictions, there will be a growing deficit of consumer goods. This policy will worsen relations between the new government and international creditors, who are already very cautious about Ukraine. Under this scenario there is a high probability that Ukraine will default on its external payments, turning into an autarky economy. This will lead to a deep economic downturn in 2000, though resource restrictions combined with ten consecutive years of decline in GDP will bring the policy into challenge. We see three possible solutions to this situation: (1) the president will change the policy himself, (2) he will be overthrown by the people, or (3) Ukraine will lose its sovereignty and unify with Russia and Belarus, solving the problem of resource restrictions in the short-run.

Last week

The Democratic Revolution in Eastern Europe Ten Years Later. On June 4-6 ICPS Director Vira Naniivska visited Budapest to participate in an international conference on "The Democratic Revolution Ten Years Later: The Accomplishment and the Challenges Ahead".

Hungary's Prime Minister Viktor Orban hosted the conference. The meeting brought together the directors and senior analysts of more than eighty CEE/NIS reform-oriented think tanks.

The agenda focused on the key economic, political, and security policy issues that confront the new democracies and their transformation and integration into the community of free nations.

This week

Discussion of economic forecasts for 2000. The Macroeconomics Seminar to be held at the International Centre for Policy Studies on 8 June will be devoted to the discussion of economic forecasts for 1999-2000. The speaker is Serhiy Il'chuk, manager of Quarterly Predictions team. The participants will discuss the following questions:

1. Predictions for 1999: assumptions, forecasts and risks.
2. Possible scenarios of economic policy.
3. Predictions for 2000: assumptions, forecasts and risks.

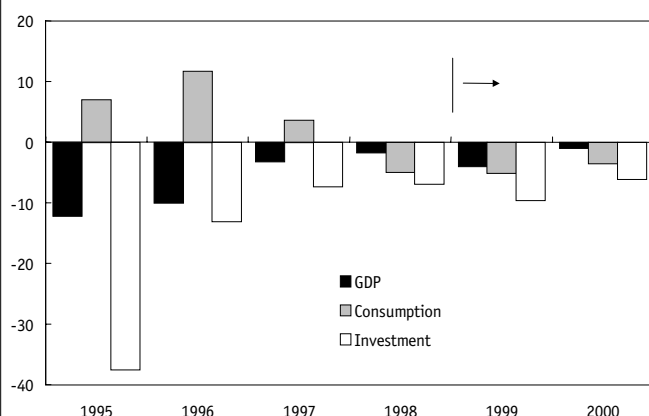
In two weeks

The target level for the government revenues in GDP. This subject is to be discussed at the ICPS macroeconomics seminar on 22 June. The presentation will be made by Apostolos Papaphilippou, economic advisor of Ukrainian-European Policy and Legal Advice Centre.

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Real GDP, real consumption and investment

Annual % change



Source: State Statistics Committee. Forecast by Quarterly Predictions

- A decline in public consumption of 2.5% of GDP compared to the first quarter of 1998, due to an increase in debt payments.

- Tight monetary policy needed to recover credibility of the hryvnia, which sharply devaluated at the end of 1998.

However, external shocks are not the only reason for the deep decline in the first quarter of 1999 nor the economic recession over the last eight years in Ukraine. In previous issues, ICPS economists discussed in detail both the main barriers that hinder economic growth in Ukraine and reforms that may remove these barriers. Now we focus on the two key problems that will lead to a 4% decline in GDP in 1999.

First, economic policy does not encourage business activities. The main characteristics of economic policy over the last several years are the following:

- The government intervenes in all economic activities, which provokes destructive corruption.
- There exists a system of rents, based on soft budget constraints for enterprises, which prevents shutting down ineffective enterprises.

To eliminate the effects of these negative factors on economic development, government capacity to think out its decisions before acting must increase. The results of these changes may become apparent in 2000, but not this year.

However, before the presidential elections in October 1999 the government will face two tasks inconsistent with the objective of putting Ukraine on the path toward economic growth:

- Maximize budget revenue to finance public consumption before the presidential elections, and
- Maintain stable exchange rate and prices, which, given the lack of confidence in state economic policy, will be done through strict restrictions of money supply.

Second, Ukraine cannot overcome the budget chaos. Over recent

years the projected numbers of budget revenue have never been realistic. To remain within the general bounds of the budget, the government applies cash control over budget expenditures (automatic sequestration of expenditures according to disposable budget revenue). This system may be used as an anti-crisis instrument in the short run, while in other cases it may lead to a catastrophe. Budget expenditures become non-transparent and ineffective, as well as inconsistent with the strategic goals of the country. Therefore, collapse of the budget sphere inhibits development of the private sector.

ICPS economists expect that at the end of 1999/beginning of 2000, the new president will make an effort to solve these problems, as a *status quo* policy will cause a deep economic downturn and sharp decline in budget revenue, which will unbalance the budget and result in government default on its debt. Quarterly Predictions economists do consider the possibility of electing a predictable president, but this variant is unlikely to develop, compared to our basic scenario.

According to Centre's forecast, economic decline in Ukraine will slow down to 1% in 2000. Irrespective of the policy implemented by the new government, political stabilization will positively effect business activities. However, the major factor will be new economic policy, which should include the following steps:

- The government must limit intervention in economic activities and cut the number of government servants.
- Taxes should be reduced and tax pressure must be distributed equally between enterprises.
- Enterprises should be liable to use their assets to pay their debts.
- The parliament should develop a realistic budget.
- Rapid cash privatization should be implemented.

Real GDP by structure

	1998 (estimation)	1999 (forecast)	2000 (forecast)
<i>Annual % change</i>			
Real GDP	-1,7	-4,0	-1,0
Real consumption	-4,9	-5,1	-3,5
Real investment	-6,9	-9,6	-6,1
<i>GDP by structure, %</i>			
GDP	100	100	100
Consumption	82,3	82,2	82,6
Private consumption	59,5	60,2	61,6
Public consumption	22,8	22	21
Investment	20,7	19,5	18,5
Private investment	19,7	18,5	17,3
Public investment	1	1	1,2
Net exports	-3	-1,7	-1,1

Source: State Statistics Committee, NBU. Calculations and forecast by Quarterly Predictions

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The International Centre for Policy Studies is an independent non-profit research organisation with the objective of improving the development process of Ukrainian policy. This is achieved by increasing the know-how of key government officials for policy choices, formulation, and debate, and the awareness of the public-at-large of the benefits of policy.

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